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Kentucky Death Taxes--Putting a Price on Inheritance

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KENTUCKY DEATH TAXES— PUTTING A PRICE ON INHERITANCE

PREFACE

There has been very little litigation interpreting the Kentucky inheritance tax law since its enactment in 1906.¹ This lack of interpretation, coupled with the vagueness of the statute and the Department of Revenue's seeming unwillingness to adopt some form of regulations to supplement the statute, has resulted in many headaches for the practicing attorney in his attempts to properly plan estates. In fact, because the federal estate tax is likely to be the decisive factor in making an estate plan, and because the same steps which save federal taxes will frequently result in a corresponding decrease in state taxes, most practicing attorneys are more familiar with the federal estate tax than with the Kentucky inheritance tax. Therefore, throughout this note there will be comparisons between the federal and Kentucky taxing provisions as a method of clarifying Kentucky's rather complicated inheritance tax scheme.

Generally, when the estate involved is relatively small, *i.e.* \$120,000 or less, Kentucky's inheritance tax will be the controlling consideration in making an estate plan. For example, consider the situation in which a decedent leaves a \$120,000 estate to his wife. No federal estate tax would be due because the decedent is allowed a marital deduction² on one half of the property left to his surviving spouse and the tax on the remaining \$60,000 can be reduced to zero by applying the specific exemption.³ Thus, such an estate would only be subject to the Kentucky inheritance tax, which in the case of a surviving wife starts at \$10,000.⁴

Chart 1⁵ demonstrates the importance of the Kentucky inheritance tax in relation to small estates.

¹ The original statute was enacted in 1906. The statute as it appears today was enacted as § 4281a of CARROLL'S KY. STAT. in 1936, redesignated as chapter 140 of KY. REV. STAT. [hereinafter cited as KRS] at the time of the general revision in 1942, and amended in 1948 to change the inheritance tax to an estate tax for estates in excess of three million dollars.

² INT. REV. CODE OF 1954 [hereinafter cited as CODE] § 2056.

³ *Id.* § 2052.

⁴ KRS § 140.080(1)(a) (1960) grants a \$10,000 exemption to the wife's inheritable interest; § 140.080(1)(b) grants a \$5,000 exemption to the husband's inheritable interest.

⁵ This chart was compiled by the Legislative Research Commission from 8,853 returns filed with the Kentucky Department of Revenue for a twelve month period, 1959-60. COMMONWEALTH OF KENTUCKY LEGISLATURE RESEARCH COMMISSION RESEARCH REPORT, INHERITANCE AND ESTATE TAXATION IN KENTUCKY 38 (1961).

SIZE OF ESTATE	LESS THAN \$30,000 %	\$30,000 TO 60,000 %	\$60,000 TO 100,000 %	ABOVE \$100,000 %	AVERAGE %
Percentage of Returns Subject to Ky. Tax	33.43	97.32	100.00	99.31	73.35
Percentage of Returns Subject to Federal Tax	—	2.02	51.58	92.05	35.90
Kentucky Death Tax as a % of the Total Tax	100.00	97.00	67.52	21.90	23.53

Chart 1

Analysis Of Death Tax Liability

INTRODUCTION

To introduce the subject of the Kentucky inheritance tax it may be helpful to consider briefly some of the basic ideas about death taxes. Before attempting to make fine judicial distinctions between estate and inheritance taxes, death taxes in general may be defined as taxes levied on the transmission of property at death or on the transmission of property in which the occasion of the transfer is so closely related to the death of the decedent that it comes within the general scope of such taxation. Although the tax is measured by the property transferred at death, it is important to note that the tax is not levied on the property itself but on the transfer or the transmission of such property. Death is the occasion and the transfer of property to the living is the object on which the tax is immediately imposed. This distinction is not merely technical but has some rather far reaching practical effects, particularly concerning the Constitutional nature and validity of death taxes.

Death taxes, both estate and inheritance, are designated as excise taxes—a term which is used to describe or designate a tax that is levied on a privilege or an occasion or happening rather than on property directly. This designation is of the essence in the Constitutional field because a direct tax is subject to Constitutional limitations or restrictions such as apportionment⁶ and equality, whereas an excise tax is not. On this basis the Supreme Court upheld the Constitutionality of a federal inheritance tax in *Knowlton v. Moore*⁷ and later the federal estate tax in *New York Trust Company v. Eisner*.⁸

The fundamental nature of the estate and the inheritance tax is more easily understood if one keeps in mind that "death is the gene-

⁶ U.S. CONST. art. I, § 9.

⁷ 178 U.S. 41 (1900).

⁸ 256 U.S. 345 (1921).

rating source from which the particular taxing power takes its being.”⁹ This concept not only permits the tax to be based on the actual estate which the decedent owned at death, but sometimes on property no longer owned at death, as in the case of transfers made in contemplation of death or the vesting of a joint estate through right of survivorship.¹⁰ That is, even though the transfer may have been completed during the life of the decedent, the tax will be imposed on the transmission of the property if the transfer was testamentary in character and had an immediate relation to the death of the decedent.

Death taxes are imposed under two principal types of levy. An estate tax is a tax imposed upon the privilege of transmitting property at death and is called a *transfer tax*.¹¹ An inheritance tax is a tax imposed upon the privilege of receiving property from a decedent at death and is called a *succession tax*.¹²

Although both of these taxes are theoretically identical, there are substantial administrative differences between them. Under the estate tax, the levy is directed against the net estate as an entirety and the net estate is the measure of the tax.¹³ The rates are progressive and depend on the size of the net estate. There is no concern with the pro rata share of each beneficiary or, except in the case of a surviving spouse,¹⁴ with the relationship between the decedent and the beneficiary. On the other hand, an inheritance tax is a tax on the right to receive property and, therefore, the bequests to each beneficiary are treated separately.¹⁵ The inheritance tax rates are progressive but, unlike the estate tax, they may fluctuate depending upon the relationship between the decedent and the beneficiary.¹⁶ Since the inheritance tax is calculated on each specific bequest at a progressive rate, the total tax may be reduced by increasing the number of beneficiaries.

The necessity of valuing the interest of each beneficiary according to his “share” and relationship to the decedent can result in complications as well as additional computations. Therefore, it is generally agreed that the estate tax is less complicated to administer. But, in spite of its comparative ease of administration, only the federal govern-

⁹ *Knowlton v. Moore*, 178 U.S. 41, 56 (1900).

¹⁰ Gifts in contemplation of death are taxed under CODE § 2035 and KRS § 140.020 (1942). Joint interests in property are taxed under CODE § 2040 and KRS § 140.050 (1942).

¹¹ C. LOWNDES & R. RAMER, *FEDERAL ESTATE AND GIFT TAXES* 2 (2d ed. 1962).

¹² *Id.*

¹³ CODE §§ 2001, 2051.

¹⁴ *Id.* § 2056.

¹⁵ KRS § 140.010 (1942). Under this provision the tax is computed upon the full and fair cash value, at the time of death, of the share that passes or accrues to each beneficiary, subject to his exemption.

¹⁶ KRS § 140.070 (1948).

ment and eleven states¹⁷ use the estate tax system. The remainder of the states, with the exception of Nevada which has no death taxes, use an inheritance tax. In order to take advantage of the maximum federal credit allowed, many of these states, including Kentucky,¹⁸ use some form of estate tax as well.

The General Assembly of Kentucky first enacted a five per cent inheritance tax in 1906. The levy was on property ". . . which shall be transferred by deed, grant, sale or gift, made in contemplation of the death of the grantor or bargainor, or intended to take effect in possession or enjoyment after such death."¹⁹ There have been subsequent revisions in rates, exemptions and inclusive provisions, but the general levying provision quoted above remains substantially the same in the present section 140.010 of the Kentucky Revised Statutes [hereinafter KRS]. In thirty-six sections, the statute levies the tax, lists the types of transfers covered, establishes exemptions, deductions, credits and rates, and describes the administration of the tax. Basically, the tax is imposed at a graduating rate of from two to sixteen per cent upon three classes of beneficiaries, each with different exemptions.²⁰

Kentucky's inheritance tax was upheld in the early case of *Booth's Executor v. Commonwealth*.²¹ The executor attacked the statute on the grounds that the Kentucky Constitution included no provision authorizing the imposition of such tax, that the statute did not tax property uniformly as required by the Constitution and that the statute would result in discrimination and inequality because of the classification of beneficiaries. The Court answered the first contention by saying:

As the privilege of right to take property by inheritance or devise is not a natural or inherent right of persons, but is a creature of the law, it is subject to regulation by statute; and the imposition of a tax as incident to the right is authorized under our governmental system, when not expressly forbidden by the State Constitution. . . .²²

¹⁷ Alabama, Arizona, Arkansas, Florida, Georgia, Mississippi, New York, North Dakota, Oklahoma, South Carolina and Utah.

¹⁸ KRS § 140.130 (1942) levies an estate tax on all estates equal to the amount by which the credits for state death taxes allowable under the federal tax law exceeds the tax levied under KRS § 140.010 (1942), less the discount allowed under KRS § 140.210 (1942), if taken by the taxpayer. Kentucky has another estate tax provision which applies when the fair cash value of the net estate equals three million dollars or more. KRS § 140.065 (1948) provides that such estates are only subject to the estate tax levied by this provision which shall be equal to the amount of the credit allowable for state death taxes under the applicable federal tax law.

¹⁹ Ky. Acts, ch. 22, at 240 (1906).

²⁰ KRS §§ 140.070 140.080 (1948).

²¹ 130 Ky. 88, 113 S.W. 61 (1908).

²² *Id.* at 97-98, 113 S.W. at 63.

The Court went on to say that the tax need not be uniform since the tax was on the transmission of property and not on the property itself and that regardless of how many separate classes of beneficiaries were established the tax was not considered to be discriminatory as long as it operated impartially upon all persons within a classification.²³

TRANSFERS SUBJECT TO TAX

The primary purpose of the federal estate tax and the Kentucky inheritance tax is to tax the transfer of property at death. More fits of possession and enjoyment of property from the dead to the specifically, their purpose is "to tax the shifting of the economic benefiting."²⁴ The federal statute accomplishes this by defining the gross estate in section 2031 of the Internal Revenue Code of 1954 [hereinafter Code] as including all property that the decedent owned at the time of his death, by determining the taxable estate under section 2051 and by imposing the tax on the taxable or net estate under section 2001.

The above sections, without more, would be limited to taxing testamentary and intestate transfers since the gross estate only includes the value of the property that the decedent owns at the time of his death. This would permit a decedent to reduce his gross estate by making a technical transfer of property during his life while retaining control and enjoyment of that property until his death. Thus, he would be passing economic benefits at his death but avoiding the tax since he would not own the property at his death.

To prevent such results Congress enacted the so-called "inclusive" provisions of the statute for the purpose of supplementing and plugging the loopholes in section 2031. These inclusive provisions, Code sections 2034-2042, provide for the equivalent of testamentary transfers and make the value of such property includible in the gross estate. The Kentucky statute also has inclusive provisions²⁵ and, consequently, if a beneficiary receives property from a decedent other than by will or intestacy it will be taxed if the transfer had substantial characteristics of being testamentary.

There have been Constitutional fights over the various "inclusive" provisions but space will not permit a survey of each of those considerations. While these provisions have been held Constitutional, the manner in which they are administered and the various detailed fact situations may continue to be a fruitful area of litigation.

²³ *Id.* at 104, 113 S.W. at 65.

²⁴ *Gregg v. Commissioner*, 54 N.E.2d 169, 170 (Mass. 1944).

²⁵ KRS §§ 140.020-140.050.

INCLUSIVE PROVISIONS

A. Introduction

The purpose of this introduction is to point out to the reader where we have been and where we are going. Other than the general background, the reader should realize at this point that both the federal and the Kentucky statutes have a basic provision of general coverage that imposes a tax on the value of property transferred at death. Quite obviously these basic provisions include the value of property that is transferred by will or by the laws of intestate succession. It has also been pointed out that under both statutes the substantial equivalents of testamentary transfers are also taxed under the so-called "inclusive" provisions. Most importantly, the reader should realize that before a death tax can be levied there must be identifiable property (such as real property or tangible or intangible personal property), the decedent must have an interest in that property and the transfer must be one that is taxable under the statute.

What remains is to develop an understanding of the inclusive provisions, which determine what transfers are subject to tax and the provisions dealing with rates, deductions and exemptions. Therefore, the remaining portion of this note will be an amplification and explanation of these provisions. There is no attempt to be exhaustive, but rather to explain the operation of each section, to discuss enough cases to bring into focus the main problems involved and, hopefully, to make suggestions that will lessen or avoid the problems.

Chart 2 is a schematic portrayal of the federal estate tax provisions.²⁶ Asterisks have been placed next to the inclusive provisions to enable the reader to see their place, purpose and function in federal estate tax scheme. Chart 3 portrays the Kentucky inheritance tax provisions for the purposes of comparison. Again, asterisks have been placed next to the inclusive provisions.

For the most part, the comparison is valid. However, the reader must keep in mind the basic differences between an estate tax and an inheritance tax and realize that the block representing "gross inheritance" refers to the total inheritance of a single beneficiary. Also, it should be noted that the federal inclusive provisions taxing retained reversionary interests and annuities have no counterparts in the Kentucky statute. Nevertheless, it is submitted that both reversionary interests and annuities are subject to the Kentucky inheritance tax and, therefore, they will be discussed. Finally, note that the Kentucky

²⁶ Chart 2 was prepared by Professor Robert G. Lawson of the University of Kentucky College of Law who kindly consented to its publication here.

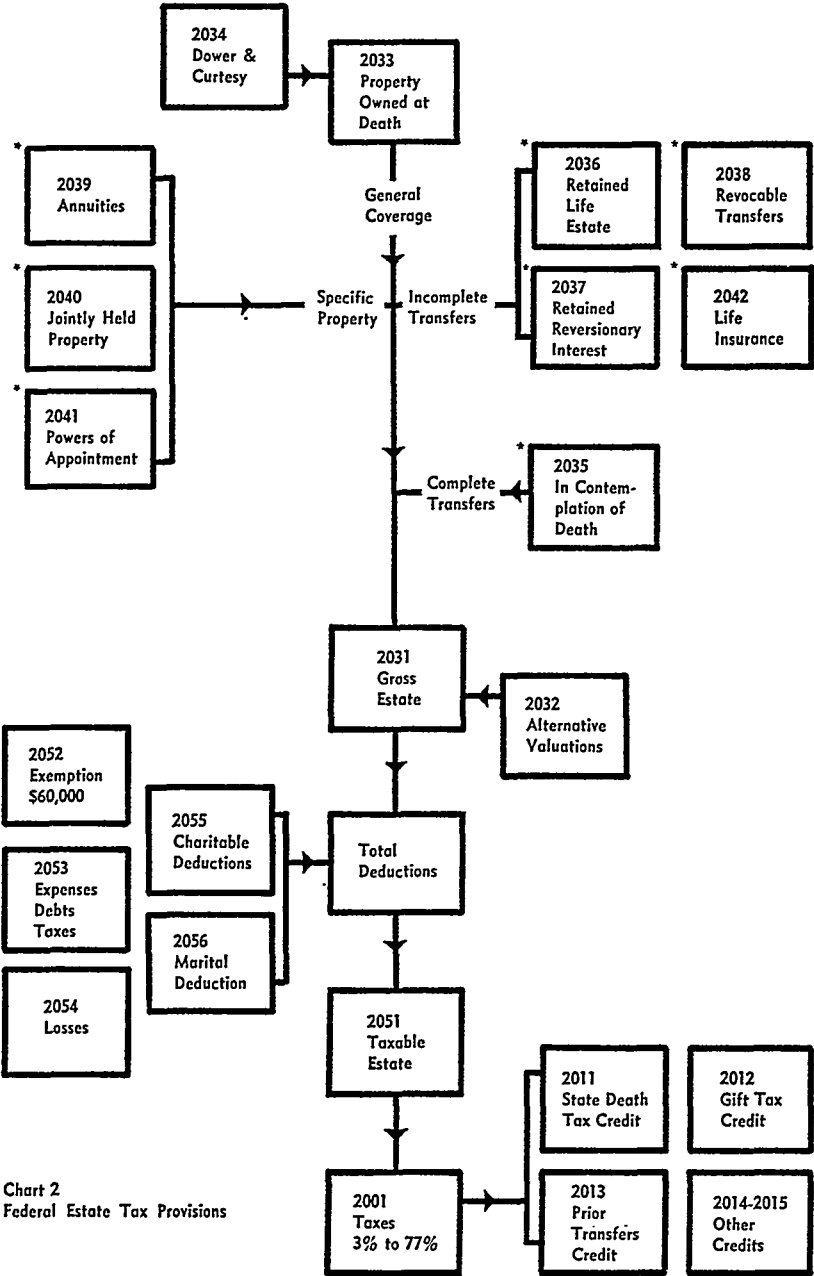


Chart 2
Federal Estate Tax Provisions

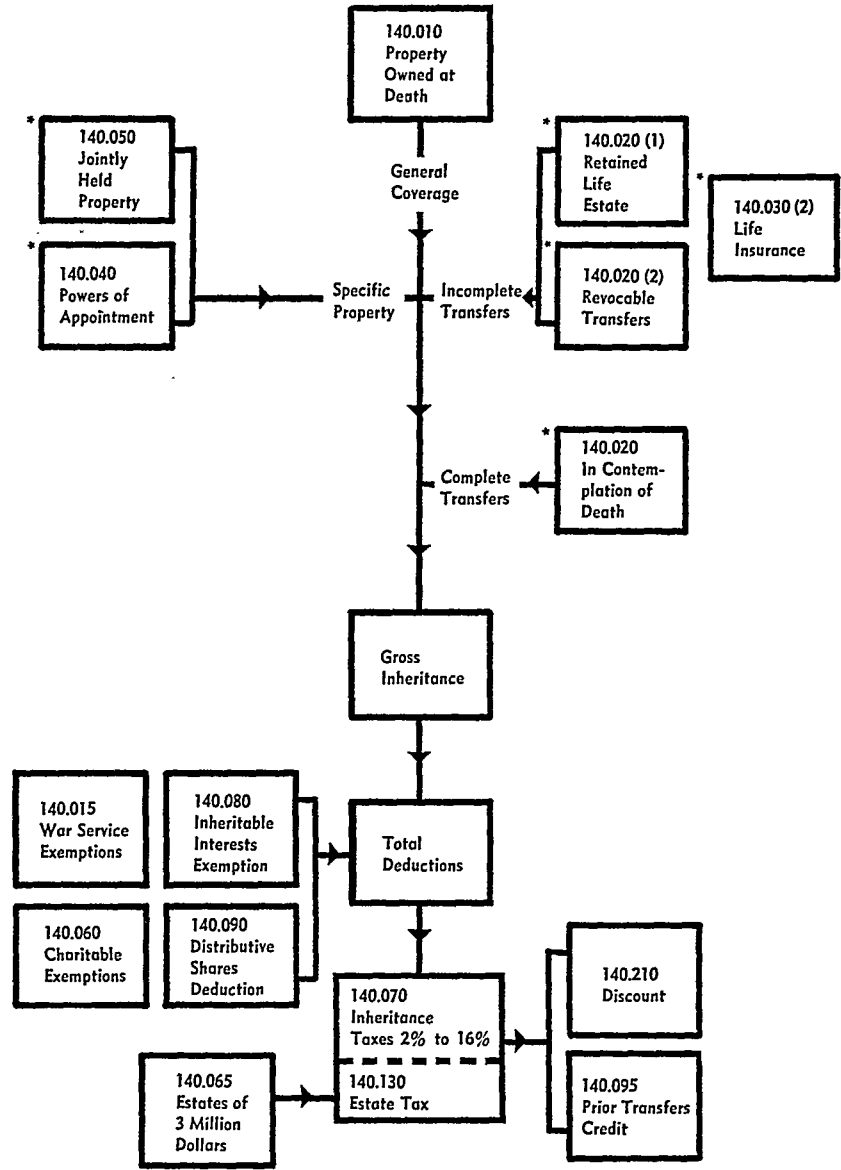


Chart 3
Kentucky Inheritance and Estate Tax Provisions

statute, unlike the federal, has no specific exemption or marital deduction.²⁷

B. Gifts in Contemplation of Death

Gifts that are made in contemplation of death are subject to the federal estate²⁸ and the Kentucky inheritance²⁹ tax. Unlike the Kentucky statute, Chapter 12 of the Code imposes a gift tax on all gifts made during life and later grants a credit if it is determined that the value of the gift is includible in the gross estate because, *e.g.*, it was made in contemplation of death. The purpose of the federal gift tax provisions is, of course, to supplement the federal estate tax provisions by taxing gifts whose value would otherwise make up a part of the gross estate. The federal gift tax as well as a man's natural reluctance to lose control over his property before his death deters decedents from completely depleting their estate prior to their deaths in order to avoid federal and state death taxes. Also, a determination that a gift was made in contemplation of death would subject it to both the estate and the inheritance tax.

The purpose of the federal and state provisions taxing transfers in contemplation of death is to reach substitutes for testamentary dispositions and thereby prevent avoidance of the estate and inheritance tax provisions. The problem in this area has been in determining when a transfer was made in contemplation of death.

While the interpretation of the phrase ['in contemplation of death'] has not been uniform, there has been agreement upon certain fundamental considerations. It is recognized that the reference is not to the general expectation of death which all entertain. It must be a particular concern, giving rise to a definite motive. The provision is not confined to gifts *causa mortis*, which are made in anticipation of impending death, are revocable, and are defeated if the donor survives the apprehended peril.³⁰

A gift then is made in contemplation of death when it is motivated by the thought of death. The "thought of death" lies somewhere between two extremes, namely, the knowledge that each of us has that we will die and the knowledge that death is imminent. Possibly a more helpful way of viewing the area between the two extremes would be to think in terms of determining whether the decedent's motive in making

²⁷ KRS § 140.080(1)(a) (1960) gives a surviving wife a \$10,000 exemption and 140.080(1)(b) gives a surviving husband \$5,000 exemption. However, these exemptions are insignificant when compared with the specific exemption and marital deduction under the federal Code.

²⁸ CODE § 2035.

²⁹ KRS § 140.020 (1942).

³⁰ *Basket v. Hassell*, 107 U.S. 602, 609-10 (1882).

the transfer was to achieve some objective after his death. At any rate, it should be clear that the fact that death ensues shortly after the gift or that a person does not believe himself to be in danger of immediate death is not determinative. The question is necessarily subjective and the answer must always be found in the decedent's motive in making the transfer. Nevertheless, in determining the subjective motive the courts look to the objective criteria³¹ presented by all of the circumstances surrounding the transfer. Some of the objective factors that have been considered by the courts are the age, health, attitude and propensities of the decedent, the amount of the property transferred in proportion to the amount of property retained, the relation of the donees to the decedent, past gift patterns, the nature of the property transferred and the nature of the decedent's motives.³² A list of all the possible objective factors would only be limited by the number of possible fact situations and combinations of circumstances. Finally, when motives associated with life and motives associated with death are both responsible for a transfer, the dominant and impelling motive of the decedent in making the transfer will be determinative.³³

The first Kentucky provision taxing gifts made in contemplation of death was enacted in 1924. It provided that every transfer of property within three years of death was conclusively presumed to have been a transfer in contemplation of death and taxable.³⁴ This provision was held unconstitutional in *State Tax Commission v. Robinson's Executor*.³⁵ In 1936, the General Assembly changed the wording to "shall be construed *prima facie* to have been made in contemplation of death"³⁶ and thus placed the burden of overcoming the statutory presumption on the person claiming the gift. This is the wording of the present KRS 140.020(2) which also provides that it is a question of fact for the proper tribunal whether a transfer made more than three years prior to the decedent's death was made in contemplation of death.

With the exception of the conclusive presumption, there have been no federal or state Constitutional problems with taxing gifts in contemplation of death. The primary difference between the federal and the Kentucky provisions concerns transfers made more than three

³¹ *Estate of Johnson v. Commissioner*, 10 T.C. 680, 688 (1948).

³² *Id.*

³³ *United States v. Wells*, 283 U.S. 102, 115 (1931).

³⁴ Ky. Acts, ch. III, at 331 (1924).

³⁵ 234 Ky. 415, 28 S.W.2d 491 (1930).

³⁶ Ky. Acts. (Special Revenue Session), ch. 8, at 104 (1936), Ky. Stat. § 428a-13 (Carroll, 1936).

years prior to the donor's death. Under the federal statute³⁷ there is a conclusive presumption that gifts made more than three years prior to the donor's death are not made in contemplation of death, while under the Kentucky statute it is question of fact for the proper tribunal.

C. Incomplete Transfers

In addition to taxing gifts in contemplation of death or "complete" transfers, KRS 140.020(1) also attempts to tax inter vivos, "incomplete" transfers, *i.e.*, retained interests. It uses the old language of the federal estate tax Code: ". . . transfer intended to take effect in possession or enjoyment at or after death." This provision specifically includes transfers with a retained life estate and transfers with a retained power to designate who shall enjoy the property or the income therefrom. It also specifically includes transfers over which the decedent retained a power to revoke.

The federal statute no longer taxes incomplete transfers under one section but has specific sections for each type of incomplete transfer. Retained life estates and retained powers to designate who shall enjoy the property or income therefrom are dealt with under Code section 2036. Section 2037 covers retained reversionary interests that exceed five per cent of the value of the property and section 2038 deals with revocable transfers.

It is not clear whether the language of the Kentucky statute includes the reversionary interests that are taxed under Code section 2037. This is the kind of interest that had been included under the old federal Code language by the case law.³⁸ There has been no Kentucky case directly in point, but a recent Court of Appeals decision³⁹ would seem to indicate that retained reversionary interests would be subject to tax. The Court of Appeals addressed itself to the meaning of the phrase "intended to take effect in possession or enjoyment at or after death." The Court indicated that it was sufficient to impose the tax when the beneficiary did not come into possession or enjoyment until the death of the decedent if some incident of ownership passed from the decedent at death. Under this interpretation, Kentucky would tax reversionary interests but, unlike section 2037, without regard to whether the reversionary interest exceeded five per cent of the value of the property. However, it would seem that the Kentucky legislature

³⁷ CODE, § 2035(b).¹

³⁸ *Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929).

³⁹ *Kentucky Department of Revenue v. American Nat'l Bank*, 425 S.W.2d 281 (1968).

should give some thought to enacting a similar requirement so as to prevent the taxation of possible reversions that are so remote as to be merely theoretical.

D. Life Insurance

Under certain circumstances both the federal⁴⁰ and Kentucky statutes tax the proceeds of insurance policies on the life of the decedent. KRS § 140.030(2), the relevant Kentucky provision, is less complicated and affords more favorable tax treatment than does the federal provision. The only time that proceeds of an insurance policy will be subject to the Kentucky inheritance tax is when they are payable to the decedent or his estate. Even though the proceeds are payable to the decedent or his estate they will pass tax free if they are payable under a United States Government or National Service life insurance policy issued by or through the federal government.

The three cases⁴¹ that have dealt with this provision indicate that it is as straightforward as it appears to be and that its purpose is to tax life insurance proceeds which actually pass through the insured's estate by reason of his death or testamentary disposition. In all these cases the beneficiaries of the policies were the trustees of an inter vivos trust created by the decedent. In the *Luckett*⁴² case an interpretation of the following statutory language was involved:

The proceeds of an insurance policy payable to a . . . trustee of a designated beneficiary shall be tax-free.⁴³

The controversy centered on the word "designated" and the question was whether the beneficiaries under the trust had to be designated in the insurance policy. The Court said that the statute required only that some beneficial interest be created in someone other than the insured prior to his death and that it was sufficient if the beneficiaries could be identified from the trust arrangement.⁴⁴

In the *Kentucky Trust Company*⁴⁵ case the trust agreement gave the life income beneficiary the power to appoint the remainder on her death. The Department of Revenue took the position that the power of appointment made the insurance proceeds taxable because KRS 140.040(2) provides for the valuation of property which passes at the death of the donor under a power of appointment. The Court said:

⁴⁰ CODE § 2041.

⁴¹ Kentucky Bd. of Tax App. v. Estate of Porter, 422 S.W.2d 895 (1968); Kentucky Trust Co. v. Department of Revenue, 421 S.W.2d 854 (1967); Luckett v. First Nat'l Lincoln Bank, 409 S.W.2d 518 (1966).

⁴² Luckett v. First Nat'l Lincoln Bank, 409 S.W.2d 518 (1966).

⁴³ KRS § 140.030(2) (1956).

⁴⁴ Luckett v. First Nat'l Lincoln Bank, 409 S.W.2d 518 at 521 (1966).

⁴⁵ Kentucky Trust Co. v. Department of Revenue, 421 S.W.2d 854 (1967).

[T]he power granted is simply a beneficial interest in the proceeds. It is not carved out of the estate of the deceased and has no significance or value apart from the property to which it attaches. The statute declares the insurance proceeds tax-free. We must accept this plain direction.⁴⁶

This same result was reached in the *Porter*⁴⁷ case which presented

In considering the proceeds of life insurance, the estate planner's greatest concern will have to be with the federal statute since, under Code section 2042, life insurance proceeds are not only taxed when payable to the insured or his estate, but also, when the insured possessed any of the "incidents of ownership" in the policies at death. Since an insured may want to divest himself of the incidents of ownership and continue to pay the premiums on the policies, an estate planner has to be aware of the ramifications of these acts under the federal gift tax provisions.⁴⁸ For example, a gift of an insurance policy in trust and premium payments in subsequent years will not qualify for the annual exclusion if the gift to the beneficiary is a future interest.⁴⁹ The main thing to remember in estate planning is to divest the insured of all "incidents of ownership," including the power to designate the beneficiary, in such a way that the proceeds can not return to him or his estate. This is usually accomplished by naming secondary beneficiaries and providing that in no event are the proceeds to return to the insured or his estate.

E. Annuities

The existing Kentucky statute makes no mention of annuities, but the Department of Revenue has claimed that they are taxable. In fact, the Kentucky inheritance tax form⁵⁰ provides in Schedule F that annuity contracts that continue payments after the death of the decedent are taxable and must be included in the tax return.

In attempting to tax annuities the Department of Revenue relies on a pre-1954 federal Code theory. Prior to the enactment of section 2039 into the Code the Commissioner of Internal Revenue would attempt to tax survivor annuities under section 2037 (transfers intended to take effect at death) or section 2033 (property owned at death). Section 2033 is the general coverage provision of the federal statute

⁴⁶ *Id.* at 856.

⁴⁷ Kentucky Bd. of Tax App. v. Estate of Porter, 422 S.W.2d 895 (1968).
an indistinguishable set of facts.

⁴⁸ CODE ch. 12.

⁴⁹ CODE § 2053(b).

⁵⁰ Commonwealth of Kentucky, Department of Revenue, Inheritance and Estate Tax Return 63A120.

and it has its counterpart in KRS § 140.010. Section 2037 is comparable to KRS § 140.020.

The federal government had little success under these theories and the Kentucky Department of Revenue has had little more. In *Kentucky Department of Revenue v. American National Bank*,⁵¹ the Commonwealth was relying on the theory of "possession or enjoyment at death" under KRS §§ 140.010 and 140.020. The Court held, however, that the mere fact that the beneficiary did not come into possession or enjoyment until death was not enough to impose the tax. There must also be some incidents of ownership passing from the decedent at death.⁵² Nevertheless, the Department of Revenue still maintains its position and it may be less expensive to pay the tax on the annuity than to get involved in litigation for failing to pay it.

F. Joint Property

Taxation of jointly held property passing from the decedent to the survivor is easily determined under the Kentucky inheritance tax statute. KRS § 140.050 covers all types of joint ownership, including joint tenancies, tenancies by the entirety, tenancies in common, and joint bank accounts. The effect of the statute is to treat all joint property, for inheritance tax purposes, as tenancies in common. As a result, the surviving joint tenant is treated as if he inherited one half of the property from the deceased. In other words, the respective contributions toward purchasing the jointly held property are irrelevant.

The federal estate tax provision⁵³ differs in that the portion of the jointly held property to be included in the decedent's gross estate is based on the percentage of his contribution to the total cost of the property.⁵⁴ This percentage is applied against the fair market value of the entire property on the date of the decedent's death. Whether treatment would be more favorable under the federal or Kentucky provision would depend on whether the largest or smallest contributor died first.

⁵¹ 425 S.W.2d 281 (1968).

⁵² *Id.* at 282.

⁵³ Code, § 2040.

⁵⁴ On determining the portion of jointly held property that will be includible in the decedent's gross estate the Code looks to the original source of the property. Code section 2040 assumes the jointly held property originally belonged to the decedent and gives the taxpayer the burden of proving that part of the property "originally belonged" to the surviving joint owner. The taxpayer must show further that the surviving joint owner's contribution to the tenancy and the consideration with which it was acquired was not received from the decedent for less than adequate consideration.

KRS § 140.055 deals with the joint ownership of United States bonds. If such bonds were received by the joint tenants other than by purchase for full consideration in money, they are to be taxed just as other joint property under KRS § 140.050. However, if they were purchased by one or both of the joint owners, the taxation is dependent upon the respective contributions of the two parties. If the deceased made all of the contribution, then the total amount of the bond will be taxable to the survivor.

G. Powers Of Appointment

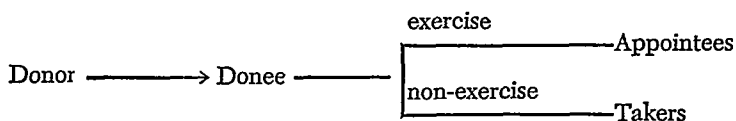
The provisions taxing powers of appointment are the most difficult to understand—this is particularly true of the Kentucky provision which is a product of amendment and addition. The first statute was enacted in 1924 and was amended and added to in 1936, 1942 and 1948.⁵⁵ This tacking process, as opposed to a complete redraft into a smoothly integrated whole, is not only responsible for the piece-meal appearance of the provision but also for the confusion and inconsistencies that have surrounded it. It is submitted that the court decisions, briefs and other writings on the subject have done little more than add to the confusion, perhaps even more so than is warranted by the statute. At any rate, a person today can find authority for almost any position he wishes to take regarding taxation of powers of appointment.⁵⁶ For these reasons and in the interests of simplicity, the Kentucky provision should be revised. However, the provision is not beyond comprehension and an attempt will be made to explain it.

The purpose of the federal and Kentucky statutes is to prevent avoidance of death taxes by the use of powers of appointment when they are created and/or exercised in such a way as to make them the substantial equivalents of testamentary transfers. A power of appointment is created when the owner of property gives another person the power to dispose of the property subject to the limitations of the

⁵⁵ Ky. Acts, ch. III, at 331 (1924); Ky. Acts, ch. 8, at 104 (Special Revenue Session 1936); Ky. Acts, ch. 204, at 895 (1942); Ky. Acts, ch. 96, at 225 (1948). The original statute and amendments thereto have been construed in *Ream v. Department of Revenue*, 314 Ky. 539, 236 S.W.2d 462 (1951); *Allen's Ex'r v. Howard*, 304 Ky. 280, 200 S.W.2d 484 (1947); *Reeves v. Fidelity & Columbia Trust Co.*, 293 Ky. 544, 169 S.W.2d 621 (1943); and *Commonwealth v. Fidelity & Columbia Trust Co.*, 285 Ky. 1, 146 S.W.2d 3 (1940).

⁵⁶ For example, the Legislative Research Commission states that Kentucky taxes the full value of the property subject to the power twice, once on the death of the donor and again on the death of the donee. COMMONWEALTH OF KENTUCKY LEGISLATION RESEARCH COMMISSION, INHERITANCE AND ESTATE TAXATION IN KENTUCKY 14 (1960). Another authority says that if the property subject to the power is taxed on the death of the donor it will not be taxed on the death of the donee. CCH INH., ESTATE AND GIFT TAX REPORT, ¶ 1540.

power. The creator or donor of the power can create either a general or special⁵⁷ power of appointment in the holder or donee of the power. The donee holds a general power of appointment when he can appoint the property to anyone he chooses or to a limited group which includes the donee, his estate or his creditors. If the donee is limited to the extent that he cannot appoint himself, his estate or his creditors then he is said to possess a special power of appointment. The persons who take the property under an exercised power of appointment are referred to as appointees, while those who receive the property when the donee fails to exercise his power are referred to as takers. This process is portrayed as follows:



As previously indicated, tax consequences may vary depending upon how the power of appointment was created and exercised. The donor will create the power during his lifetime or by will and the power will be general or special and may or may not be accompanied by a life estate in the donee. The donee will either, during his lifetime or by his will, exercise his power of appointment, or die without having exercised it, or allow it to lapse. In the latter two situations the takers will most likely be the intestate heirs of the donor unless the donor has expressly provided who the takers should be in the event the donee fails to exercise his power. These then are all of the possibilities for creation and exercise and their effect on tax consequences will be discussed shortly.

It is important to note that under substantive property law⁵⁸ the donee does not have title to the property over which he holds a power of appointment. Title remains in the donor until it vests in the appointees or takers and the donee is considered the intermediary or conduit through which the title flows. Conceptually then, traditional property law views the vesting of title in the appointees or takers as a transfer from the donor, not the donee.

In the absence of a specific provision this manner of viewing the process could, under certain circumstances, result in tax avoidance. For example, if a testator left his son a life estate in and a general

⁵⁷ For a discussion of the distinction between general and special powers of appointment and their treatment under the CODE, see C. LOWNDES & R. KRAMER, *FEDERAL ESTATE AND GIFT TAXES* 262 (2d ed. 1962).

⁵⁸ For a general discussion of powers of appointment under substantive property law see T. BERGEN & P. HASKELL, *PREFACE TO ESTATES IN LAND AND FUTURE INTERESTS* 152-82 (1966).

power of appointment over a piece of property and the son exercised his power by will in favor of his children, there would only be death taxes on the one transfer from the testator to his grandchildren. In reality there were two transfers which should have been subject to tax since what the son received, enjoyed during his lifetime, and transferred on his death was a virtual fee simple ownership. Additionally, a problem of complexity would result under the Kentucky inheritance tax scheme since the relationship that will determine rates⁵⁹ and exemptions⁶⁰ will not be known until the ultimate beneficiaries of the property are determined. This may be several years after the death of the donor because of the intervening life estate of the donee. However, these problems only result from viewing the process under substantive property law. What Kentucky has done is to legislate around them.

The Kentucky inheritance tax treatment of powers of appointment is set out in the five subsections of KRS § 140.040. What the statute has done is to create two taxable events, one when the power is created and another when it is exercised. The power is taxed when created only if it is created by will; and it is taxed when it passes from the donee to the ultimate distributee only if the power is exercised by will or the donee fails to exercise his power. If the power is created and exercised *inter vivos*, there will be no inheritance tax because there will have been no transfer at death.

Subsection 2 deals with powers created by the donor in his will. It uses the rates and exemptions in effect at the death of the donor. As indicated above, unless the power is exercised at the death of the donor the ultimate distributee may not be known for several years. Subsection 2 solves this problem by choosing a prospective beneficiary and calculating the rates and exemptions on the basis of this choice. The tax is levied against the corpus which the power controls. If it subsequently develops that the wrong beneficiary was chosen, then appropriate adjustments will be made at that time. The selection of a beneficiary at the death of the donor is somewhat arbitrary, but without this selection it would be impossible to calculate the tax until the donee exercised the power. The relationship which governs the rates and exemptions is the relationship between the donee and the prospective beneficiary.

A typical example of how subsection 2 is applied would be where A by his will creates a life estate in B with a general power of appointment over the remainder. On A's death the value of the life estate

⁵⁹ KRS § 140.070 (1948).

⁶⁰ KRS § 140.080 (1960).

would be calculated by the use of mortality tables and *B* would be taxed for it under the general taxing provisions. The remainder would also be taxed on *A*'s death and the tax would be levied against the property. Before the tax could be determined, it would be necessary to choose a prospective beneficiary who would most likely be *B* or his family. If *C*, *B*'s son, is chosen as the most likely beneficiary, the rate and exemption would be determined by the relationship between *B* and *C*. The rate and exemption applied in this situation would be the rate and exemption that was in effect at *A*'s death. Had this been a special power of appointment, the relationship between the class and *B* would govern since the class would be chosen as the most likely beneficiary.

In the preceding discussion, only the taxation of a power created by will has been considered. This is the first taxable event. The second taxable event occurs when the donee fails to exercise his power or exercises it in his will. However, it is submitted that this event will not be taxed where there has already been a tax levied on the first event under subsection 2. Subsection 1 makes it possible to tax the second event by treating the donee as the absolute owner of the property controlled by the power. This treatment is directly contrary to substantive property concepts and if it were not for subsection 1, this event could not be taxed.

In most situations the donor will name takers in case the donee fails to exercise his power. Subsection 1 treats the failure of the donee to exercise his power as a transfer from the donee to the takers. When this occurs the rates and exemptions applied are those in effect at the donee's death. The relationship that governs for purposes of determining the rates and exemptions is the relationship between the donee and the takers.

When the donee exercises the power by will, subsection 1 treats this as a transfer from the donee to the appointees. Again, the applicable rates and exemptions are those in effect at the donee's death and the governing relationship is the one existing between the donee and appointees.

Up to this point the discussion has considered subsections 1 and 2 separately. The real difficulty arises when both subsections are applicable. Subsection 2 is not applicable unless the power is *created* by the will of the donor and subsection 1 is not applicable unless the donee either *exercises* the power by will or fails to exercise it. In a situation where the power is created in the donor's will and the donee exercises by will or fails to exercise, it would appear that an inheritance tax could be levied under subsection 2 and again under sub-

section 1. However, this has never been done in Kentucky; and, apparently, if the tax is levied under subsection 2 when the donor dies, there will be no levy under subsection 1. If for some reason there was no tax levied under subsection 2 on the death of the donor, then it will be picked up under subsection 1 on the death of the donee. The rates and exemptions applied in this situation are those in effect at the donor's death.

From the above, it would appear that Kentucky follows substantive property law in viewing the process of transfer via a power of appointment as a single transfer from the donor to appointees or takers. But for tax purposes two transfers or taxable events are recognized by statute so as to insure that the single transfer is taxed. If this is the case then the theory must be that since the beneficiary only receives the property one time and since an inheritance tax is a tax imposed on his right to receive property, it would be unjust to tax that right twice.

It would seem that this is a situation where Kentucky should, like the federal statute, draw a distinction between general and special powers of appointment and tax them differently. If this distinction were made, special powers of appointment would be taxed as indicated in the preceding paragraph. However, a general power of appointment is the equivalent of a fee ownership in the donee and, therefore, the equivalent of a complete transfer from the donor to the donee. Viewed in this manner, the inheritance tax should be levied under subsection 2 on the donee beneficiary's right to receive the property from the decedent donor. Then when the donee passes the property on his death, by exercise or default, a tax should be levied against the appointee's or taker's right to receive the property from the decedent donee. This would seem to be a better approach and a court could so hold under this provision as it now stands. However, general and special powers of appointment consistently have been taxed in the same manner and the Department of Revenue has been satisfied if a tax was levied on the donor's death.

A discussion of the relevant federal provision would not be worthwhile in light of the detail that would be required to make it meaningful and the substantial difference in the manner of taxing powers of appointment. However, Chart 4, an attempt to schematically summarize what has been said about KRS § 140.040, does not lend itself to a brief and basic comparison. Perhaps a few comments on the chart would be helpful.

- (1) The Kentucky statute makes no distinction between general and special powers; they are taxed alike. The federal statute

CREATION: DONOR TO DONEE

KIND OF POWER	TIME OF CONVEYANCE	FEDERAL	KENTUCKY
General or Special	Inter Vivos Testamentary	Gift tax Est. tax	No tax Inh. tax

EXERCISE: DONEE TO
APPOINTEES OR TAKERS

General	Inter Vivos Exercise Testamentary Exercise Non-Exercise	Gift tax Est. tax Est. tax	No tax Inh. tax Inh. tax
Special	Inter Vivos Exercise Testamentary Exercise Non-Exercise	No tax No tax No tax	No tax Inh. tax Inh. tax

Chart 4

Taxation Of Powers Of Appointment

makes a distinction but it is only meaningful when there has been a transfer from the donee to the appointee or takers.

- (2) Kentucky has no gift tax but the federal statute does. Consequently, all inter vivos transfers will be subject to the federal gift tax except the inter vivos *exercise* of a special power of appointment.
- (3) If property passes by the inter vivos or testamentary *exercise* or *non-exercise* of a *special* power of appointment, the value of the property will not be included in the gross estate of the donee under the federal estate tax.
- (4) Where the chart indicates that a transfer is subject to the federal gift tax, it may also be subject to the federal estate tax if it would be includible under §§ 2035 through 2038 (this was not indicated on the chart).
- (5) Non-exercised powers are subject to the Kentucky inheritance tax. However, only a non-exercised general power is subject to the federal estate tax.
- (6) The treatment of powers of appointment under section 2041⁶¹ of the Code depends on the date the power was created.⁶² Chart 4 indicates the treatment of powers of appointment created after October 21, 1942.

⁶¹ CODE § 2041 is limited to the taxing of donated powers, *i.e.* it specifies the circumstances under which the value of the property subject to the power will be included in the gross estate of the donee. Retained interests are taxed under § 2036-2038.

⁶² The difference in treatment under CODE § 2041 can be briefly summarized. The release or non-exercise of a general power of appointment created on or before October 21, 1942 is not taxable. Release or non-exercise after that date is treated as an exercise and taxable. Additionally, if a general power created on or before October 21, 1942 was reduced to a special power before November 1, 1951 it will be treated as a special power and non-taxable. If it was reduced to a special power after that date it will be treated as the exercise of a general power and taxable.

RATES

The Kentucky inheritance tax rates are listed in KRS § 140.070. The rates are divided into classes and the applicable class will depend upon the relationship of the beneficiary to the decedent. There are three classes of beneficiaries provided for in the statute. Class A includes members of the immediate family, going all the way through to the grandchildren. It also includes adopted children, if adopted when infants,⁶³ and stepchildren. Class B includes brothers and sisters, aunts and uncles, sons-in-law, daughters-in-law, nieces and nephews. Class C includes everyone not in Class A or B. Rates are lower in Class A than in B and lower in B than in C.

The problem under this provision and its solution were discussed under powers of appointment. The problem, of course, is that this type of classification makes it impossible to determine the rates and exemptions until the beneficiary is known. It will be recalled that the solution under the Kentucky statute is to choose the most likely beneficiary and make adjustments later if someone else receives the property.

It should be noted that the rates are set in such a way as to subject even small inheritances to the tax. Thus in the many situations where there is no federal estate tax imposed on the decedent's estate there will nevertheless be an inheritance tax imposed on his beneficiaries. However, the inheritance tax rates only run to 16 per cent whereas the federal rates run as high as 77 per cent.⁶⁴

EXEMPTIONS

The exemptions from the Kentucky inheritance tax are listed in KRS § 140.080. They are based to some extent upon the rate classes. The wife or infant child get a \$10,000 exemption. All others in Class A get a \$5,000 exemption. Persons in Class B get \$1,000 and those in Class C get \$500. The exemptions are subtracted from the beneficiary's share before the tax is calculated.

Where the decedent dies intestate, KRS § 391.030(1)(6) becomes applicable. This is the homestead provision and under it personal property or money up to \$1,500 is exempt for the benefit of the decedent's widow and infant children. It should be pointed out that the

⁶³ At common law a child is an infant until he reaches the age of majority. KRS § 2.015 (1968) changed the age of majority in Kentucky from twenty-one years of age to eighteen. This provision has been effective since June 13, 1968.

⁶⁴ CODE § 2001.

homestead exemption is written in terms of widows and children but not husbands.

DEDUCTIONS

The Kentucky inheritance tax deductions listed in KRS § 140.090 are a separate and distinct category from the exemptions. The relationship between the decedent and the beneficiaries is not a factor; rather, the deductions are specifically named items which may be deducted. The deductions are debts of the decedent, accrued taxes, federal estate taxes, funeral expenses, executor's commissions and costs of administering the estate of the decedent including the attorney fees. The attorney fees are limited to those actually paid.

There is a charitable deduction statute in Kentucky⁶⁵ with much the same type of provisions as the federal statute.⁶⁶ It is limited to charitable, educational, or religious purposes, but also includes transfers to cities, towns and public institutions in this state for public purposes. There is the requirement that none of the officers, members or stockholders of the charitable organization can be receiving a pecuniary profit from its operations.

CREDIT FOR TAX ON PRIOR TRANSFERS

KRS § 140.095 allows the legatee a credit against the inheritance tax if the property was transferred to his immediate decedent within five years and a tax paid on that transfer. For the legatee to be entitled to this credit, the property must be identified as having been so transferred and taxed, or identified as the property exchanged for such property. If part of the previously taxed property is conveyed to more than one beneficiary, the credit allowable is divided among the several beneficiaries, in proportion to the amount of the previously taxed property received. The credit is limited to the extent that it shall not exceed an amount equal to such proportion of the total tax due as the value of the previously taxed property bears to the value of all property transferred to the legatee.

ADDITIONAL TAX

If after calculating the tax as provided in all the other provisions, the inheritance taxes paid are less than the maximum allowable credit under the federal estate tax,⁶⁷ there is an additional amount due

⁶⁵ KRS § 140.060 (1954).

⁶⁶ CODE § 2055.

⁶⁷ CODE § 2053(d)(1).

equal to the difference between the tax due and the credit.⁶⁸ This serves merely to get the state part of the federal tax.

DISCOUNT

KRS § 140.210 provides for a discount of five per cent if the tax is paid within nine months of the decedent's death. It also provides that no interest will be due if the taxes are paid within eighteen months, but a penalty of ten per cent per annum will be charged thereafter. The ten per cent penalty is reduced to a six per cent per annum charge when the delay is unavoidable or due to the litigation of a claim against the estate.

CONCLUSION

This note has attempted to explain the Kentucky inheritance tax provisions through a comparison with their estate tax counterparts in the federal Code. The comparison reveals several areas in which the Kentucky tax law is in need of revision. If the present inheritance tax system is to be maintained, the provision dealing with powers of appointment needs to be revised, and new provisions dealing with annuities and retained reversionary interests need to be enacted.

The best solution, however, would be to abandon the inheritance tax structure altogether and to replace it with an estate tax system⁶⁹ along the lines of the federal Code. The deterring factors to such a change would be the initial cost involved and the fact that no differentiation among classes of beneficiaries is possible with an estate tax. It is submitted that these factors are offset by the reduction in administrative costs, the ultimate increase in revenue, and the fact that such a tax structure would be more easily understood by taxpayers, lawyers, accountants and trust officers. These are the people most directly affected by death tax laws and they should be able to determine in advance the tax consequences which will result from the use of various estate planning devices.

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⁶⁸ KRS § 140.130 (1942).

⁶⁹ The Legislative Research Commission has already drafted a "Proposed Kentucky Estate Tax Statute," COMMONWEALTH OF KENTUCKY LEGISLATIVE RESEARCH COMMISSION, INHERITANCE AND ESTATE TAXATION IN KENTUCKY 59-89 (1961).

⁷⁰ *Editor's Comment:* This note is the product of extensive personal research and analysis of the Kentucky inheritance tax law by the author, but it should be pointed out that Mr. Winkler used an unpublished note written by Robert L. Fears as a model for much of his research. Mr. Fears' note was based on an idea developed by Gary Conn, John T. Mandt, and Charles Marshall. [Mr. Fears is a 1969 graduate of the University of Kentucky College of Law; Mr. Conn, Mr. Mandt and Mr. Marshall are 1968 graduates of the University of Kentucky College of Law. All are former staff members of the *Kentucky Law Journal*.]